United States Senate

Republican Policy Committee

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June 15, 2004

RPC Backgrounder

Federal Terrorism Reinsurance: A Solution or a Problem?

Executive Summary

- The purpose of this paper is to provide background on the "Terrorism Risk Protection Act of 2002" (TRIA) and examine arguments for and against its extension.
- TRIA was intended to guard against economic dislocation caused by the unavailability or extraordinary expense of terrorism insurance following the terrorist attacks of September 11th, and to provide the insurance industry with a transition period to develop the capacity to provide terrorism insurance without government involvement.
- According to the General Accounting Office (GAO), "TRIA has improved the availability of terrorism insurance, especially for some high-risk policyholders," and "ensure(d) that business activity did not materially suffer from a lack of terrorism insurance."
- But, as GAO also notes, insurers "have made little movement toward any mechanism that would enable insurers to provide terrorism insurance to businesses without government involvement."
- Although TRIA is not set to expire until December 31, 2005, Congress may not have the luxury of waiting to act: as early as September of this year, insurance underwriters will begin writing policies for coverage that will extend beyond the program's expiration date. This is consequential because primary insurers already have begun to petition state regulators for terrorism exclusions on coverage that extends beyond January 1, 2006.
- Many argue that Congress must extend TRIA because, otherwise, terrorism insurance will soon become scarce, coverage prices will rise, and overall business activity will suffer as a result.
- Others suggest that TRIA should not be extended because it is the program itself that is primarily responsible for the failure of private-sector alternatives to develop. As Senator Phil Gramm, then Ranking Member of the Senate Banking Committee, argued two years ago: "Two years from now, if we don't change this bill, we are going to be back here, and the same people who are saying today we have to have this bill are going to say: You have to extend this bill for another two years, another 10 years, forever."

Introduction

On November 26, 2002, President Bush signed into law the "Terrorism Risk Protection Act of 2002" (TRIA or "the Act," P.L. 107-297) to "establish a temporary Federal program that provides for a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism."[1] Congress passed TRIA to ensure that overall economic activity did not suffer from the lack of affordable terrorism insurance, and to provide the insurance industry with a transition period to assess and price the risks presented by international terrorism.[2]

TRIA contained two fundamental elements to address potential market disruptions: a three-year terrorism insurance "backstop," whereby the Federal Government would assume losses caused by foreign terrorist attacks above company-specific deductibles; and a two-year requirement that property and casualty insurers must "offer terrorism insurance with terms, amounts, and other coverage limitations materially similar to those that apply to other protected property and casualty losses."[3] The Act leaves to state law the regulation of insurer pricing and the approval of insurer policy forms.

Although TRIA is not set to expire until December 31, 2005, a number of factors may induce Congress to consider an extension of the law before adjournment of the 108th Congress. The most critical factor is that, as early as September of this year, insurance underwriters will begin writing policies for coverage that will extend beyond the program's expiration date.

Another factor is that the Treasury Department, in accordance with the Act, is currently determining whether it should extend the terrorism insurance mandate (commonly referred to as the "make available" provision) for a third year.[4] Congress has no role in this decision, which must be made before September 1, 2004, but both House and Senate committees with jurisdiction over the insurance industry recently held hearings to provide their Members with an opportunity to express their views.[5]

Meanwhile, an exhaustive Treasury study required by the Act to determine the program's effectiveness is not due to Congress until next June. Due to market pressures, Congress may not have the luxury of waiting until after June 2005 to act. Now may be the best time for policymakers to decide if an extension is warranted. In its consideration, Congress should focus on whether an extension is the solution or the problem – i.e., whether terrorism insurance will become scarce without an extension of the Act or whether the market will adjust and offer viable insurance (or capital market alternatives) if the government backstop were removed.

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[1] House Report 107-779, Conference Report to accompany H.R. 3210, the "Terrorism Risk Protection Act," November 13, 2002.

[2] Richard J. Hillman, "Effects of the Terrorism Risk Insurance Act of 2002," General Accounting Office, GAO-04-720T, April 28, 2004.

[3] TRIA, §103(c)(1)(B).

[4] Assistant Treasury Secretary Wayne A. Abernathy in Testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House of Representatives Committee on Financial Services, April 28, 2004.

[5] House Capital Markets Subcommittee hearing was April 28, 2004. The Senate Banking Committee hearing was May 19, 2004.

The Aftermath of September 11th for Terrorism Insurance: 2001-2002

The old insurance axiom, "there's no such thing as a bad risk, but only a bad price" has been called into question by the estimated $40 billion in insured losses inflicted by the September 11th terrorist attacks.[6] While in many ways the insurance industry's reaction to September 11th was very similar to that which has followed previous catastrophic losses, such as Hurricane Andrew in 1992,[7] it was different in that many questioned whether terrorism risk could ever be priced.[8] Some contended it could be, but that time was necessary to construct models to gauge risk exposure, the likelihood of another attack, and loss distributions. Others flatly asserted that the risk of catastrophic loss was incalculable, irrespective of the amount of time granted for analysis and reflection.[9]

The Original Rationale for Legislation: A Temporary Tool During a Transition Period

Federal legislation was contemplated immediately following the attacks, when the insurance market "hardened" dramatically. Reinsurers,[10] who are expected to pay about two-thirds of the final insured cost of the attacks, alerted their primary property and casualty insurance company clients that they intended to stop offering reinsurance for terrorism acts after January 1, 2002, the date when an estimated 70 percent of reinsurance treaties were set to expire.[11] Primary insurers responded by requesting that state regulators allow them to exclude terrorism coverage in their policies.[12] This "domino effect" was expected to force property owners, leaseholders, lenders, and other policyholders to self-insure against the risk of losses from another terrorist attack. The potential for economic dislocation posed by this scenario led many in Congress to the conclusion that federal intervention was necessary.[13]

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[6] Jeffrey R. Brown, Randall S. Kroszner, and Brian H. Jenn, "Federal Terrorism Risk Insurance," National Bureau of Economic Research, Working Paper 9271, May 2002.

[7] Following Hurricane Andrew in August of 1992, which caused $15.5 billion in insured losses, insurance availability receded, reinsurance rates increased by 75 percent, and five bills were introduced in Congress to provide a federal backstop for hurricane losses. Kent Smetters, "Insuring Against Terrorism: The Policy Challenge," Conference of the Brookings—Wharton Papers on Financial Services, February 2, 2004.

[8] Unlike terrorism risks, data on losses caused by hurricanes have been compiled for decades and scientific predictions of seasonal hurricane activity have been made since 1984, and so no one could *credibly* suggest that insurers could not model this risk. M.A. Saunders, "Hurricane Variability and Catastrophic Risk," *Insurance Institute of London*, October 29, 1998.

[9] Michelle E. Boardman, "Known Unknowns: The Delusion of Terrorism Insurance," May 2002. This pricing uncertainty led reinsurers to flee the market to a far greater extent than after other catastrophic losses.

[10] Reinsurance is essentially insurance for insurance companies. Most primary companies retain only part of the exposure to loss on any given portfolio of risks. Primary or direct insurers "lay off" or cede some of their exposure to loss to reinsurers. The amount of exposure an insurer lays off to reinsurers varies among carriers. The less primary risk that the company retains, the more premium it has to pay to the reinsurer to assume the excess exposure. GAO, "Terrorism Insurance: Rising Uninsured Exposure to Attacks Heightens Potential Economic Vulnerabilities," GAO-02-472T, February 27, 2002.

[11] Daniel B. Rubock and Tad Philipp, "CMBS: Moody's Approach to Terrorism Insurance for U.S. Commercial Real Estate," *Moody's Investors Service*, March 1, 2002.

[12] GAO, February 27, 2002.

[13] Senate Banking, Housing and Urban Affairs Committee Hearing on Terrorism Risk Insurance, October 24, 2001.

2001: Senators Thwarted in Attempting to Provide a Legislative Response

The "domino effect" described above presented a public policy challenge because most commercial loan documentation requires property owners or leaseholders to purchase insurance as "the lender may reasonably require," which in most cases was "all risk" insurance that included terrorism coverage.[14] The fear was, in the words of Senator Charles Schumer, "If we don't have terrorism insurance … then your banks, whether they be in small towns or in large cities, will not lend to new projects. They may not even refinance existing loans, and that means … new projects come to a halt. No more new jobs. No construction jobs. No jobs that those projects create."[15]

In October of 2001, the leadership of the Senate Banking Committee (Senators Dodd, Sarbanes, Gramm, and Enzi) and the Treasury, acting on behalf of the administration, agreed to a bill that would provide a temporary federal backstop for catastrophic losses. Under the provisions of the agreement, once the insurance industry's terrorism losses for the year exceeded $10 billion, the Federal Government would cover 90 percent of additional losses. This arrangement would last for two years, at which time the Treasury Secretary could extend the program for a third year, with the industry-wide deductible increasing from $10 billion to $20 billion.[16] The agreement also required that insurers must include terrorism insurance in all of their property and casualty policies to be eligible to participate in the program, and established a legal regime where any claims for damages or personal injury or death would be consolidated in a single federal district court with punitive damages prohibited.[17]

Despite the bipartisan nature of this compromise, the agreement was unable to move forward due to Democrat objections to the ban on punitive damages. Majority Leader Daschle not only refused to bring a bill to the floor that banned punitive damages, but even refused to allow a vote on an amendment to prevent punitive damage awards.[18] As a result, no bill reached the Senate floor before the session ended in December of 2001.

Meanwhile, in November of 2001, the House originated and passed its bill to provide federal assistance for two years to insurers for insured losses resulting from an act of terrorism. The bill contained a complicated trigger mechanism, set at $1 billion for industry-wide losses, or 10 percent of an individual insurer's capital surplus and 10 percent of its net written commercial property and casualty premiums. The bill also included a taxpayer-payback mechanism to require the industry to repay any assistance it received, a ban on punitive damages, and a cap on attorneys' fees at 20 percent of court-awarded damages.[19]

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[14] *Moody's*. "All risk" insurance means "all risks" of physical loss or damage that aren't specifically excluded, such as war risk, flood, earthquake, and nuclear, chemical, or biological damage. However, lenders typically require additional insurance in high-risk areas, such as those prone to earthquakes and floods. Most modern property insurance policies no longer use the term "all risk," although they operate in the same manner.
[15] Senator Charles Schumer, *Congressional Record*, S13687, December 19, 2001.
[16] Senator Paul Sarbanes (D-MD); Senator Phil Gramm (R-TX); Senator Mike Enzi (R-OH); Senator Chris Dodd (D-CT), *press conference*, Senate Radio and TV Gallery, November 1, 2001.
[17] Senator Paul Sarbanes.
[18] Senator Thomas Daschle, in response to a modification request by Senator Mitch McConnell, *Congressional Record*, S13865, December 20, 2001.
[19] H.R. 3210, "Terrorism Risk Protection Act," passed House November 29, 2001.

2002: Banks and Insurers React to Failure to Pass Insurance Backstop

With Senate legislation stalled by Democrat insistence on punitive damage awards, and reinsurers still unwilling to reenter the market, the result was that banks, insurers, property owners, and leaseholders entered 2002 with the prospect of the severe economic dislocation that the immediate legislative response was designed to prevent. At the start of 2002, 45 states and the District of Columbia approved primary insurers' requests to exclude terrorism coverage from commercial property and casualty policies, except those involving workers' compensation.[20]

Given that 10 percent of insurers' losses from the World Trade Center attack represent payments for workers' compensation claims, this state coverage mandate was not trivial.[21] Moreover, in nearly half the states, property insurers were required to provide coverage for "fire following" an event, including a terrorist act, in standard property and casualty policies.[22] Since it could be argued that most of the insured damages inflicted on September 11th were the result of the "fire following" the planes' impact, this state mandate, when coupled with workers' compensation, threatened insurer solvency.

Aside from these state requirements, the fear that additional terrorism insurance coverage would become unrealistically expensive in the face of the Federal Government's silence largely was realized.[23] The entirely new post-September 11th insurance situation posed financial uncertainties for both lenders and borrowers, which required an ad hoc, case-by-case response.

Lenders, faced with the prospect of not only default, but also a low recovery value in the event of a terrorist attack, were exposed to far more risk and had little guidance as to how to deal with this new situation.[24] Because in real estate lending loans are secured against property, the unavailability or extraordinary expense of terrorism coverage challenged the basic premise of such lending by introducing the possibility of having the loan collateral destroyed by a terrorist attack.[25] On the one hand, lenders who believed the property they had underwritten was a terrorist target and had a high risk of total destruction (i.e., a tall office building as compared to a retail shopping mall) preferred that the borrower purchase terrorism insurance at virtually any price. On the other hand, if the price of the insurance was so exorbitant that it threatened the financial viability of the asset (i.e., the cost of premiums compromised the cash flow necessary for the property owner to make on-time mortgage payments), the lender typically allowed the borrower to forego insurance until it was more commercially reasonable.

According to an April 2002 Federal Reserve survey, domestic banks typically asked for additional collateral and modified existing loan covenants to allow for partial coverage if borrowers could not find affordable, comprehensive terrorism insurance.[26] Having to revise

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[20] GAO, February 27, 2002. At no time have biological, chemical or nuclear events covered.
[21] GAO, February 27, 2002.
[22] GAO, April 28, 2004. Standard fire policy laws, with late 19th century origin, mandate certain coverage and terms that must be provided in a property policy.
[23] *Moody's*.
[24] Georgette Chapman Poindexter, "Drafting for Unseen Risk in the CMBS Market," paper presented at the Robert Kratovil Memorial Lecture in Real Estate at John Marshall Law School, May 2002.
[25] *Financial Times*, "The High Cost of Terrorism,", October 4, 2002.
[26] Federal Reserve Board of Governors, Senior Loan Officer Opinion Survey on Bank Lending Practices, April 2002. Available online at: http://www.federalreserve.gov/boarddocs/snloansurvey/200205/default.htm.

performance expectations for existing loans and re-price future credit offerings to account for terrorism risk contributed to the decline in commercial mortgage lending and construction in 2002. The Real Estate Roundtable identified $15.5 billion in real estate transactions that were delayed or cancelled due to terrorism concerns.[27] In addition, uncertainty over terrorism insurance delayed or cancelled projects that caused the loss of an estimated 300,000 construction jobs.[28]

November 2002: Terrorism Risk Insurance Act Enacted

Following the midterm elections in November of 2002, the commercial real estate market was relieved of the uncertainty and complications posed by a dysfunctional insurance market through the enactment of TRIA. Instead of providing an industry-wide reinsurance backstop and prohibiting punitive damages, as in the original agreement between the Senate Banking Committee leadership and the Bush Administration, TRIA created annual insurer-specific deductibles for three years, allowed for unlimited punitive damages, and provided for a taxpayer-payback mechanism somewhat similar to the one included in the original House-passed bill.[29]

The 18 months since TRIA's passage have given analysts and stakeholders the chance to assess the program's effectiveness. According to the General Accounting Office (GAO) "TRIA has improved the availability of terrorism insurance, especially for some high-risk policyholders," and "ensure(d) that business activity did not materially suffer from a lack of terrorism insurance."[30] Although comprehensive pricing information is not yet available,[31] a broad geographic study by Marsh, Inc. in February 2003 found that terrorism pricing averaged between 8 percent and 10 percent of the all-risk premium, which many view as "reasonable."[32] Groups representing both lenders and policyholders have expressed their general satisfaction with TRIA, believing that terrorism coverage could not exist on the same terms without it. These groups have strongly urged the Treasury to extend the "make available" provision for an additional year.[33]

The main concern GAO expressed has been that "take up rates" – the percentage of eligible policyholders electing to purchase terrorism coverage – have been low.[34] GAO estimates that only 10 percent to 30 percent of policyholders have purchased terrorism coverage,

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[27] Real Estate Roundtable, "Survey Confirms Economic Toll of Terrorism Insurance Gap: Over $10 Billion of Real Estate Projects Affected Across U.S," September 4, 2002.
[28] President George W. Bush, "President Reiterates Need for Terrorism Insurance Agreement," October 3, 2002.
[29] The insurer deductible was 1 percent of the insurer's direct earned premium for the remainder of 2002, 7 percent for 2003, 10 percent for 2004, and 15 percent for 2005. The payback provision allows the government to require insurers to assess a policyholder surcharge of not more than 3 percent of the policy premium per year to recover taxpayer assistance up to total industry losses of $10 billion in 2003, $12.5 billion in 2004, and $15 billion in 2005.
[30] GAO, April 28, 2004.
[31] The Department of the Treasury is currently conducting a comprehensive national survey to compile the cost of terrorism coverage, basic deductibles, and its cost relative to total insurance as part of the June 2005 report due to Congress.
[32] Marsh Inc., cited in Kent Smetters.
[33] Statement of the Mortgage Bankers Association, and the Coalition to Insure Against Terrorism.
[34] The Mortgage Bankers Association recently release a study of the commercial mortgage market, which found that by March/April 2004 lenders responsible for 94 percent of the commercial mortgage debt surveyed required terrorism insurance coverage. The study also found little or no correlation between loan size and coverage requirements. "Study of Terrorism Insurance, TRIA, and the 'Make Available' Provision," June 2, 2004.

while Treasury puts the figure at between 25 percent and 30 percent.[35] While this seemingly low demand may not be a sign of the program's ineffectiveness – the decision to purchase coverage depends on company-specific, risk-adjusted probabilities of loss – it could pose a problem for insurers if the only entities that purchase coverage are the ones most at risk.[36]

This problem, known as "adverse selection," could threaten insurer solvency in the event of attack by preventing the industry from effectively pooling risk and building adequate reserves.[37] However, adverse selection could exist with or without TRIA, the only difference being that insurance rates for those properties that most need it would be much higher. It is also important to note that the concept of adverse selection may not be applicable to terrorism insurance at all even though prices are set higher for dense urban areas, based on best-guess estimates. Since insurers and policyholders cannot be entirely sure about terrorists' motives or methods, buildings presumed to be "high risk" targets may not be at risk at all.[38]

Arguments for Extending TRIA

According to GAO, insurers still have "not found a reliable way to price their exposure to terrorist losses" absent a federal backstop.[39] This is of great concern *now* because insurers, as early as September of 2004, will begin to write policies with effective dates beyond the end of the current program. Given that timeframe, some policymakers, including House Capital Markets Subcommittee Chairman Richard Baker, suggest temporarily extending the program before the Congress adjourns this year.[40]

Extension Would Avoid Market Uncertainties

Although TRIA has made coverage more available and affordable, supporters of an extension argue such success would be ephemeral if coverage is not available when the program expires on December 31, 2005. Supporters argue that if Congress were to extend the program this year, those uncertainties, and the potentially harmful economic consequences they entail, would be avoided.

As evidence of the likelihood that terrorism insurance will be unavailable if TRIA is not extended, supporters of an extension point to the fact that primary insurers already have begun to petition state regulators for terrorism exclusions on coverage that extends beyond January 1, 2006.[41] Similarly, a recent statement released by eight insurance trade associations argues

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[35] GAO, April 28, 2004; Undersecretary of Domestic Finance Brian Roesboro in testimony before the Senate Committee on Banking, Housing, and Urban Affairs, May 18, 2004.
[36] As the MBA study makes evident, lender requirements greatly affect a policyholder's decision to purchase terrorism coverage.
[37] Boardman.
[38] Jeffrey Manns, "Insuring Against Terror?" *Yale Law Journal*, June 2003.
[39] GAO, April 28, 2004.
[40] Baker in questioning before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House of Representatives Committee on Financial Services, April 28, 2004.
[41] Insurance Services Office, "Insurance Services Office Files Conditional Terrorism Insurance Policy Endorsements," May 3, 2004.

"terrorism risk defies normal underwriting and rating principles, effectively limiting the ability of [property and casualty] insurers to advance a private mechanism for that risk."[42]

In addition, supporters of an extension point to the fact that reinsurers "remain reluctant to provide meaningful capacity" for terrorism risk and have reentered the market very "cautiously."[43] With few reinsurers willing to share the risk in any meaningful way,[44] it seems likely that insurance exceptions will reappear and coverage prices will rise after TRIA's expiration.

Inaction Will Threaten Insurers' Solvency

Supporters of an extension also argue that a federal backstop must remain in place so long as state insurance regulators intervene in the market to mandate terrorism-related coverage. For example, 24 states currently mandate "fire-following" coverage, which, arguably, would have covered nearly all of the September 11th damages even if acts of terrorism were excluded. Thus, absent a TRIA extension, insurers will be forced to continue underwriting terrorism risks in many states without the benefit of a federal backstop.

Perhaps more consequential, the five states that prevented insurers from excluding terrorism coverage in 2002 accounted for 35 percent of the total property and casualty market.[45] Although these insurers were largely free to set prices high enough to discourage coverage for large risks, states retain the authority to regulate the price and terms of terrorism insurance.[46] And this does not even consider the problem of workers' compensation terrorism coverage, which is mandated in every state at tightly regulated prices and for which no reinsurance market has developed, or is likely to develop.[47] Proponents of a TRIA extension argue that such state intervention into the market necessitates federal assistance to preserve the viability of the insurance industry.

Better to Have a Reinsurance Policy in Place than to Rely on Ad Hoc Appropriations

Finally, supporters of a TRIA extension contend that it is far more efficient for the government to have a reinsurance plan in place before any future attacks. Because of the $20 billion appropriated following September 11th to assist in the redevelopment of lower Manhattan, there is a widespread presumption that the government provides "free, implicit insurance" via

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[42] Statement of AIA, CIAB, IIABA, PIA, PCI, RAA, SAA, and UWC (an employer organization) before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House of Representatives Committee on Financial Services, April 28, 2004.
[43] Jardine Lloyd Thompson, *Insurance Market Overview*, December 2003; GAO, April 28, 2004.
[44] Reinsurance has also become largely unavailable for group life insurers, who were not included in the backstop. TRIA instructed the Treasury to include group life in the program if the availability of group life reinsurance and group life primary insurance receded. According to Assistant Secretary Abernathy, Treasury found that group life reinsurance had receded, but primary coverage "seems to be as available today, with little change, as it was on September 10th. Because of that, the test under the statute was not made, so we could not include it in the program." Abernathy. During the Senate Banking Committee hearing, several Senators expressed support for including group life insurance in any TRIA reauthorization.
[45] GAO, February 27, 2002.
[46] New York, the District of Columbia, and Florida have capped current regulated pricing.
[47] Towers Perrin, "Workers' Compensation Terrorism Reinsurance Pool Feasibility Study," March 2004.

immediate federal aid following an attack.[48] Named the "Samaritan's Dilemma" by Nobel Laureate James Buchanan, implicit insurance guarantees encourage economic actors to not only take more risk than if no insurance existed, but also to take on more risk than if an explicit, but limited, government insurance scheme conditioned their expectations.[49] By extending TRIA, supporters contend that the federal government could actually reduce the total amount of taxpayer assistance triggered by a terrorist attack and reduce private-sector risk-taking.

Arguments Against Extending TRIA

Since TRIA was designed to be a temporary program, any extension, even for one year, could lead to further rounds of reauthorization resulting in a permanent federal reinsurance program. While temporary federal reinsurance may have been necessary in the immediate aftermath of September 11th to allow insurers to rebuild reserves[50] and to serve as a catalyst for reinsurers to reenter the market, some analysts suggest that extending TRIA would be nothing more than a permanent subsidy for the insurance industry and a few densely populated urban areas.[51] Opponents of a TRIA extension argue that allowing businesses and individuals to incorporate terrorist risks into their decision-making is the most efficient and equitable way for policymakers to proceed.

Markets Respond to Absence of Affordable Terrorism Insurance

Opponents of a TRIA extension highlight the role capital markets can play in the absence of terrorism insurance to repackage and spread the risk associated with losses from a terrorist attack. While the size of the global property catastrophe reinsurance market is estimated to be \$75 billion, the aggregate size of global capital markets is estimated to be \$30 *trillion*.[52] Similarly, while the \$40 billion in insured losses from September 11th wiped out almost 20 percent of insurers' total coverage capacity,[53] U.S. capital markets routinely lose twice that amount on a *daily* basis.[54] Thus, opponents of TRIA argue, the risks of loss from terrorism are quite manageable when judged in the proper context.

For example, capital markets proved able to digest the lack of affordable terrorism coverage in 2002 through the securitization of commercial lending. While a bank, or even a group of banks, might be unwilling to loan \$1 billion to a developer to construct a new office

[48] Brown, Kroszner, and Jenn.
[49] Randall Kroszner, "The Political Economy of Banking and Financial Regulatory Reform in Emerging Markets," *Research in Financial Service*, 1998.
[50] As many analysts have observed, the U.S. tax code restricts the supply of coverage for catastrophic loss by exposing insurers' capital to double taxation. The income generated by the assets held by an insurance company is generally subject to corporate income taxes, which reduce the earnings available for return to the owners who provided the capital. This taxation reduces insurance capacity and increases the premium that insurers must charge on catastrophic risk. See: Scott E. Harrington and Greg Niehaus, "Government Insurance, Tax Policy, and the Affordability and Availability of Catastrophe Insurance," *Journal of Insurance Regulation*, vol. 19, no. 4, Summer 2001.
[51] J. Robert Hunter, Director of Insurance, Consumer Federation of America, in testimony before the Senate Committee on Banking, Housing, and Urban Affairs, May 18, 2004.
[52] SIA Research Reports, "Terrorism Risk: Insurance Market Failures and Capital Markets Solutions," Vol. V, No. 1, January 21, 2004.
[53] Congressional Budget Office, "Federal Reinsurance for Disasters," September 2002.
[54] Smetters.

building without sufficient terrorism coverage, if that mortgage were turned into bonds and sold to 10,000 investors, the financial consequences of a loss from a terrorist attack could be diffused across enough parties to allow the project to proceed. Moreover, if that $1 billion loan were packaged with eight other $125,000 loans and then divided and sold as bonds of different tranches[55] to match the specific risk tolerance of 20,000 investors, the risk of financial loss from a terrorist attack would be even more diffused and probably far overshadowed by the risk of default presented by everyday commercial challenges.

In fact, the rapid growth of Commercial Mortgage-Backed Securities (CMBS) – bond-like instruments whose payments are backed by the principal and interest payments from commercial mortgages – is evidence of the trend towards securitization.[56] Through the issuance of CMBS, commercial mortgage originators are able to transfer default risk – the ultimate receipt of principal and the timely receipt of agreed upon interest payments – to investors by selling claims on their loans as bonds in the secondary market.

The interest rate offered on a particular bond (including CMBS) is equal to the interest rate earned on a similar U.S. Treasury security plus a risk premium (also known as the yield spread) to compensate investors for the perceived risks associated with the bond.[57] Because CMBS payments are backed by the mortgage payments on anything from a single commercial loan to a large pool of hundreds of similar commercial loans, the yield spreads on a CMBS security reflects the risk of default of its underlying mortgage(s).

Given the situation described above, in the aftermath of September 11th, one would have expected CMBS investors, who were exposed to the risk of default caused by uninsured terrorist damages, to demand higher rates of interest to compensate them for this risk. But as the Federal Reserve noted in its July 2002 Monetary Policy Report to Congress, this did not happen: "Investor appetite for CMBS has apparently been strong, as yield spreads have narrowed this year … the low level of risk spreads for CMBS suggests that concerns about terrorism insurance have not been widespread in the market for commercial mortgages."[58]

Concern about terrorism insurance was not widespread because the market responded to the September 11th attacks by accelerating the trend towards pooling loans to reduce investors' exposure to a single property. According to Patrick Corcoran, CMBS analyst at JP Morgan Securities, "The World Trade Center bonds were a single-asset deal, but after the experience with terrorism insurance … more and more larger loans have been combined with smaller loans

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[55] A 'tranche' is used in finance to define part of an asset that is divided into smaller pieces to provide investors the rights to the expected cash payments for particular periods, features, or levels of risk. 'Tranching' is utilized to improve the marketablity of typically larger assets.

[56] Commercial mortgages represent mortgage loans for commercial properties such as office buildings, multi-family dwellings, shops, restaurants, showrooms, etc. CMBS can either be composed of single-asset and large loan transactions or large pools of loans. Financial intermediaries called conduits, which connect the institutions originating the loans to the ultimate investor, typically assemble such pools. The conduit makes or purchases loans from third-party correspondents under standardized terms and then, when sufficient volume has been obtained, pools the loans for sale to investors in the CMBS market, typically first splitting the CMBS into different tranches to create different levels of risk. Credit ratings agencies typically grade CMBS based on the strength of the underlying mortgages, as well as subordination level (or tranche) of the pool.

[57] Frank J. Fabozzi, "Fixed Income Analysis," Association for Investment Management and Research, 2000. p. 45.

[58] Federal Reserve Board of Governors, "Monetary Policy Report to the Congress," Section 2, July 16, 2002.

in what are called fusion deals."[59] Whereas single-asset CMBS (like the World Trade Center) represented 18.2 percent of total CMBS issued in 2001, single-asset CMBS accounted for less than 5 percent of total CMBS issuance in 2002.[60]

As CMBS continues to grow – the value of outstanding CMBS has grown from $96 billion in 1995[61] to over $470 billion in 2003 and now represents 37 percent of commercial mortgage funding – so too will the capacity of borrowers to secure financing for projects, even in the absence of terrorism insurance.[62]

Opponents of TRIA's extension contend that propping up the traditional insurance model will only retard the market's natural development and transfer risks to taxpayers that would otherwise be diluted and spread throughout the capital markets. Focusing solely on the ability (or willingness) of insurers to offer protection from the financial risks posed by terrorism ignores the innumerable ways the capital markets can facilitate the efficient separation and reallocation of such risk.[63]

TRIA's Design is to Blame for the Lack of Reinsurance

Although supporters of a TRIA extension use the lack of reinsurance to build support for an extension, some analysts have suggested that the lack of terrorism reinsurance is largely a product of TRIA's design. These opponents argue that by changing TRIA from an industry-wide reinsurance program with a deductible of $10 billion (as originally proposed by the Senate Banking Committee leadership and Bush Administration), to an insurer-specific backstop where taxpayer assistance can begin after a loss of as little as $5 million, Congress *virtually guaranteed that no reinsurance market would develop* and TRIA would need to be extended.

When TRIA passed the Senate in June 2002, Senator Phil Gramm, then Ranking Member of the Senate Banking Committee, foretold this: "Two years from now, if we don't change this bill, we are going to be back here, and the same people who are saying today we have to have this bill are going to say: You have to extend this bill for another 2 years, another 10 years, forever."[64]

Senator Gramm argued that TRIA's company-specific deductibles – based on each company's direct earned premium – would "destroy the incentive of the industry to do the things that need to be done to get the Government out of this business."[65] Since a company-specific deductible is essentially a government reinsurance contract with each and every insurer in the industry, insurers not only have no need to pool risk and share premiums, *they are discouraged from doing so.*

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[59] Bridger Commercial Funding, "CMBS Continues to Dominate," April 27, 2004.
[60] Gail Lee and Patricia Crowell, *CMBS Market Watch Weekly*, Credit Suisse First Boston, December 12, 2002.
[61] Thomas F. Wratten, "Introduction to Commercial Real Estate Secondary and Securitization Market," October 1996. Available at: http://www.mccarystevens.com/cssa_intro.pdf.
[62] Bridger.
[63] For a more complete perspective on the evolution of risk management, the role of insurance, and behavioral finance, see Peter L. Bernstein, *Against the Gods: The Remarkable Story of Risk*, New York (John Wiley & Sons): 1996.
[64] Senator Phil Gramm, *Congressional Record*, S5648, June 18, 2002.
[65] Senator Phil Gramm, S5645.

Actuarial consultant Tillinghast-Towers Perrin (TTP) emphasized this point in its initial analysis of TRIA.[66] The report advised insurers to "estimate their deductible and develop a strategy to minimize it," and explained that insurers "will have less incentive to write coverage for layers of risk they do not expect to retain" because even if such risk is passed on to reinsurers, the direct premiums earned for the coverage would increase the company's TRIA deductible.[67]

Opponents of a TRIA extension argue that, by discouraging the kind of insurance industry cooperation that would allow the industry to build capacity and provide coverage on its own, the government will never be able to extract itself from the insurance business.

TRIA Should Not Be Extended Because it Allows for Punitive Damages

Opponents of TRIA's extension also emphasize that the program should be allowed to expire because it permits unlimited punitive damage awards, which could prove extraordinarily costly and enrich the plaintiffs' bar at the expense of victims of terrorist attacks and taxpayers. As Alice Schroeder, analyst at Morgan Stanley, has argued, the unpredictable nature of punitive and non-economic damage awards is "the single most important issue affecting the insurance industry" as it drains capacity and makes loss estimates meaningless.[68] In the context of TRIA, the potential for punitive damage awards exacerbates the difficulty of pricing terrorism risk, discourages reinsurers from entering the market, and could result in taxpayers sending billions of dollars to the coffers of plaintiffs' attorneys.

Conclusion

As the legal cliché goes, "hard cases make bad law." If Senator Gramm's analysis is correct (and the TTP study and insurance market's evolution seem to suggest it is), then TRIA could be an example of a bad law leaving policymakers with a hard case: either allow TRIA to expire and subject the market to uncertainty, higher prices, and the potential for insurer insolvency; or extend a program that likely will prevent development of a private-sector solution, thereby leaving taxpayers exposed for the reimbursement of terrorist damages in perpetuity. With the determinative Treasury study not due until June of 2005, but insurance policies covering post-TRIA risks to be written this autumn, policymakers will be confronted with this unpleasant choice very soon.

[66] Tillinghast-Towers Perrin, "Focus on the Terrorism Act," December 2002.
[67] Tillinghast-Towers Perrin.
[68] Jardine Lloyd Thompson.